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Some Questions for the European Central Bank

How exactly will its plan to buy corporate bonds work, and will it deliver the promised growth boost?

By Marcello Minenna

More than a month after the European Central Bank unveiled a new set of measures intended to boost inflation and growth in the eurozone, a big question lingers: How will these policies work in practical terms?

For one component of the ECB's new policies we already have a good idea. The central bank extended its Targeted Long-Term Refinancing Operations, or TLTRO, program. Every quarter for four quarters starting in June, the ECB will allow banks to borrow at ultralow rates so long as they use the money to support new lending. In some instances, banks may borrow at negative rates—meaning the ECB will pay the bank to borrow from it.

The first iteration of TLTRO, started in 2014, lent €400 billion ($453.3 billion) to eurozone banks at rates ranging from 0.05% to 0.15%, but managed to increase the value of business loans outstanding by only 0.6% in 2015. Now the ECB will try again, this time with more (but more complex) incentives. It also will allow banks to keep money they receive under the program but don't ultimately lend out.

The more significant unknowns, however, surround the ECB's new plan to purchase highly rated corporate bonds as part of its program to buy €80 billion in assets a month, known as quantitative easing. The ECB will be dipping into a market potentially as large as €550 billion in terms of investment-grade corporate bonds outstanding, but with the purchases due to begin by June questions still abound about how this will work.

The immediate question is how many corporate bonds the ECB will buy each month. Although at the same March meeting the ECB increased the amount of monthly purchases it makes, to €80 billion from €60 billion, it didn't specify that the additional monthly amount will exclusively take the form of corporate bonds.

The scale is likely to be much smaller. If the ECB treats its existing program to buy government bonds as a guide, its monthly purchases of corporate debt likely won't exceed 1% of the outstanding total of that debt—which would be a cap of around €5 billion a month.

That number speaks to whether this program will bring the benefits it promises. The ECB hopes that if it effectively guarantees to be a major buyer, corporate-bond prices will rise and yields will fall, encouraging more companies to issue debt to fund business expansion and the like.

Yet ECB purchases may not be of sufficient scale to achieve that effect. The eurozone corporate-bond market is neither particularly vast nor thriving. Gross monthly bond issues have declined steadily, and net monthly issues have averaged an unimpressive value of €4.6 billion over the past five years, and falling. Even aggressively implementing its new quantitative easing, the ECB would shy away from buying any more than 10% of new issues, leading to a maximum central-bank support for new bond issues of only €300 million a month.

That doesn't change the overall economic picture. Even assuming a fast expansion of net issuance in response to ECB policy, with a doubling of the average issues to €10 billion a month, that would add at most €1 billion to the rough estimate of €5 billion of monthly corporate bond purchases.

And could corporate-bond purchases even hit €5 billion per month? One must take into account the poor depth and the smaller average trade size of the eurozone investment-grade corporate-bond market—€850,000 per trade, or only 10% of the typical trade size in the government bond markets, according to J.P. Morgan. A recent spike in credit-default-swap trades seems to suggest that traders are trying to gain exposure on corporate bonds that are already scarcely available. It's prudent to further reduce the estimate of ECB monthly purchases to a maximum of €3 billion.

The second question is what will happen to all the new resources the ECB is pouring into the financial system. The poor performance of existing TLTROs and their predecessor facilities in terms of expanding credit to the economy via the bank-lending channel isn't an encouraging precedent. Nor is the track record of the government-bond purchases the ECB already has made under quantitative easing. The ECB's position as a guaranteed buyer bidding up the prices of government bonds, coupled with accounting regulations that make it favorable for banks to hold government debt, unsurprisingly has encouraged banks to hold more government debt at the expense of riskier assets such as corporate loans.

New purchases that bid up the prices of highly rated corporate bonds may have a similar effect. We can legitimately suspect that any additional liquidity that eurozone enterprises would obtain will be recycled into the financial system, encouraging mainly operations that can be traced to mere asset-liability management: reducing the debt exposures of banks, or using the windfall to increase dividends or buy back shares to boost stock prices

The new corporate program may

prove trickier than expected. The ECB will soon release further technical details on how it plans to implement this program, and the important thing to watch will be how the central bank tries to address these questions.

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